



Lean Inventory Corrections

Larger-than-anticipated inventory buildups can lead to so-called inventory corrections, which can push the economy into a recession as firms scale back production and lay off workers. There was some speculation that inventory buildup in 1994 and 1995 might herald an inventory correction and recession in 1996. Real increase in business inventories contributed \$58.9 billion to real Gross Domestic Product (GDP) in 1994. The 1995 increase in business inventories of \$33.1 billion was smaller, but could still be considered above average (see page 4). Was this inventory increase a cause for concern?

The inventory cycle is usually marked first by a rise, then a fall in the inventory-to-sales ratio. The ratio first increases, as a result of both the rise in inventory and the slowdown in sales at the beginning of a downturn, then falls as inventory overhang is corrected and sales pick up. Inventory investment began to increase in the second quarter of 1994, while the ratio of inventory to sales remained more or less flat. But the inventory-to-sales ratio had been declining since the 1990 recession and, by early 1994, was at its lowest in over two decades. So a flat ratio in 1994 reflected an end to the decline and, by 1995, the rising inventory investment began to show up as an increase in the ratio (see charts on this page and page 5). This led to the speculation by some that inventory levels were higher than desired.

To reduce the ratio, a correction to the growth of inventory was necessary. As the chart shows, reduced inventory growth in 1996 lowered the inventory-to-sales ratio even below the early 1994 level. Although inventories have again begun to increase, the ratio has

remained low and fairly steady for a number of months. This suggests that inventories are now increasing in line *with* sales, not *faster* than sales, and therefore should not require further correction. In addition, the correction did not result in severe inventory reductions, which would have subtracted from GDP. Instead, a slower rate of inventory growth was all that was required to bring inventory back in line with sales.

Because firms had been maintaining lean inventories, as indicated by the low inventory-to-sales ratio, the buildup was not as acute as it might otherwise have been, and the subsequent correction has not been as painful. A similarly mild inventory correction occurred in the middle of the expansion period in the 1980s.

The economy is subject to occasional inventory imbalances which lead to corrections. Fortunately, some inventory corrections, like this recent one, are not severe enough to precipitate a recession.

—Donald S. Allen

